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QUESTION PRESENTED

Whether New Jersey is constitutionally required to allow a state tax deduction for the federal windfall profit tax when there is no dispute that New Jersey can tax its share of an integrated oil company's pretax unitary net income.

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In The

Supreme Court of the United States

October Term, 1988

No. 87-453

AMERADA HESS CORPORATION, et al.,

Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,

Appellee.

No. 87-464

TEXACO INC. and TENNECO OIL COMPANY,

Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,
NEW JERSEY DEPARTMENT OF THE TREASURY,

Appellee.

On Appeals from the Supreme Court of New Jersey

BRIEF FOR APPELLEE

STATEMENT

Since 1958 the State of New Jersey has imposed an income-based franchise tax measured essentially by federal taxable income with certain adjustments. One of the adjustments in the 1958 legislation, which has not been changed, is the denial of a deduction for federal taxes "on or measured by profits or income." This provision is routinely applied to deny a deduction for the federal income tax and the federal minimum tax.[1] In 1980 Congress enacted the Federal Crude Oil Windfall Profit Tax Act of 1980, Pub.L. 96-223, 94 Stat. 229, 26 U.S.C. § 4986 *et seq.* (hereafter "IRC" §§ 4986 *et seq.*) to tax some of the windfall profits that oil producers were expected to receive from the federal government's decontrol of oil prices. In 1982 the New Jersey Division of Taxation determined that the windfall profit tax was a federal tax "on or measured by profits or income" and accordingly advised the appellants and other companies that they could not deduct the federal tax.

A. New Jersey Corporation Business Tax

During the years before the Court (1980 and 1981) the New Jersey corporation business tax (hereafter "CBT") was measured by the sum of a tax on net worth and a tax on net income. N.J. Stat. Ann. § 54:10A-5 (West 1986) (hereafter "N.J.S.A.") (J.S. App. 94a to 95a). (The net worth measure was subsequently repealed.

[1] The parties stipulated that the provision at issue is applied to both the federal corporate income tax and the federal minimum tax on tax preference items (J.A. 23). The New Jersey Tax Court has similarly construed the tax disallowance provision. *Texaco Inc. v. Taxation Div. Director,* 4 N.J. Tax 63 (N.J. Tax Ct. 1982). Appellants are thus incorrect in asserting that the tax disallowance provision was dormant prior to its application to the windfall profit tax (*cf.* App. B9 n.5).

1985 N.J.L. c.55). The income measure is based upon "entire net income"[2] defined as federal taxable income before the net operating loss deduction and special deductions, without certain deductions allowed under the federal income tax. N.J.S.A. 54:10A4(k).[3] The provision which is at issue here states that, "Entire net income shall be determined without the exclusion, deduction or credit of: . . . taxes paid or accrued to the United States on or measured by profits or income . . ." N.J.S.A. 54:10A-4(k)(2)(C) (J.S. App. 94a).

Once "entire net income" is determined under the CBT, the standard three-factor apportionment formula is applied to determine what portion of a multistate corporation's taxable income is derived from New Jersey activities and is subject to new Jersey's 9% tax. N.J.S.A. 54:10A-6: N.J.S.A. 54:10A-5(c) (J.S. App. 94a).

B. Windfall Profit Tax

The windfall profit tax (hereafter "WPT") came into being in 1980 as part of the Administration's program to decontrol crude oil prices because it was expected that decontrol would increase the revenues of oil producers by $14 or more per barrel and that a portion of the additional revenues would not "be taxed through the existing corporate income tax." Cong. Budget Office, *The Windfall Profits Tax: A Comparative Analysis of Two Bills* 1, 3 (Nov. 3, 1979) (hereafter *"CBO Analysis"*); H.R. Rep. No. 96-304, 96th Cong., 1st Sess. 5, 6 (1979). The WPT is imposed, not on the removal of crude oil (*cf.* App. B3),

[2] Under the CBT, no income is specifically allocated to a particular situs. N.J.S.A. 54:10A-5(c); N.J.S.A. 54:10A-6, N.J.S.A. 54:10A-4(k) (J.S. App. 94a to 97a).

[3] The relevant portion of N.J.S.A. 54:10A-4(k) is reproduced in the appendix to the Motion to Affirm in No. 87-453.

but on the windfall profit from taxable crude oil removed during each calendar quarter. IRC § 4986(a); IRC § 4996 (b)(7). The windfall profit per barrel is the difference between the removal price and the adjusted base price plus severance tax adjustment, IRC § 4988(a), and corresponds, generally, to the difference between the current market price and the price of the oil in question in 1979 just prior to decontrol. *See United States v. Ptasynski*, 462 U.S. 74, 76, 77 n.3 (1983).[4] Under IRC § 4996(f) "[T]he Secretary may adjust the removal price to reflect clearly the fair market value of oil removed." For large amounts of crude oil, integrated companies construct a removal price based on the value of the oil at distant refineries in New Jersey and elsewhere.[5]

The WPT is a percentage of the windfall profit, ranging from 70% for Tier 1 oil removed by an integrated company to 20% on newly discovered oil during 1988 and 15% thereafter. IRC § 4987; IRC § 4992(b); IRC § 613A (d)(2).

Congress' intent to tax actual profits resulting from decontrol by means of a tax resembling an income tax is

[4] For Tier 1 oil the base price is the May 1979 ceiling price for new or upper tier oil reduced by 21 cents. *IRC* § 4989(c). For Tiers 2 and 3, the base price is essentially $15.20 and $16.55, respectively, adjusted for the grade, quality, and location of the oil. Staff of Jt. Comm. on Taxation, *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980*, reprinted in 3 Tax Management Primary Sources (BNA) Current Developments, Aug. 26, 1981, at PS123, PS124.

[5] U.S. General Accounting Office, *Report to the Honorable Bill Nelson, U.S. House of Representatives, Response to Questions About the Windfall Profit Tax on Alaskan North Slope Crude Oil*, App. I at 5, 10, 12-14, 20, 28-32 (December, 1984) (hereafter *"GAO Report"*).

best demonstrated by the net income limitation, IRC § 4988(b) (hereafter "NIL"), which prevents the windfall profit per barrel from exceeding 90% of the net income per barrel. Like the computation of an income tax, the NIL computation is made at the end of a taxable year, not at the time of removal (*cf.* App. B 35), and in arriving at net income for a producing property, most production costs, other than the WPT, and many indirect costs are allowed as deductions. *Id.* The NIL substantially reduced many of the companies' WPT liabilities during the years at issue (J.A. 20 to 21).

Although Congress made the WPT deductible for federal income tax purposes, IRC § 164(a)(5), it did not preempt the states from denying a deduction for the WPT. The only Congressional reference to the state income tax treatment of the WPT appears in the tax writing committees' revenue estimates. The House Ways and Means Committee Report states that, as the WPT would "generally" be deductible for state income tax purposes, taxpayers' federal income deductions for state income taxes would be concomitantly reduced. H.R. Rep. No. 96-304 at 9. The Senate Finance Committee Report assumes that the WPT would reduce "deductible state income taxes." S. Rep. No. 96-394, 96th Cong., 1st Sess., 9 (1979). While both of these statements are true, because many states do allow a tax deduction for the WPT, there is no indication in the statute or elsewhere that Congress intended to preempt state tax laws that do not allow a deduction for the WPT.

Due to the drop in world oil prices, WPT revenues have declined significantly since 1981[6] and on August 3, 1988, Congress passed and sent to the President the Omnibus Trade and Competitive Act of 1988, H.R. 4848, § 1941, 100th Cong., 2d Sess., 134 Cong. Rec. S10737 (August 3, 1988), which repeals the WPT.

C. Appellants

The appellants are vertically integrated oil companies engaged in the exploration, production, refining, transportation, distribution, manufacture, and marketing of petroleum and petroleum products (J.A. 11).[7] Although they currently have no oil production in New Jersey (J.A. 12),[8] they have a very substantial presence in New Jersey, including, collectively, refineries, manufacturing plants, laboratories, chemical plants, offices, terminals, storage facilities, transportation facilities, and gasoline stations (J.A. 12 to 15). Exxon is a New Jersey corporation (J.A. 13). The companies both produce and purchase domestic crude oil, and once their own crude production is commingled with barrels of crude oil acquired from third parties, they have no records segregating produced from purchased barrels (J.A. 18). Most of the companies

[6] According to the United States Treasury Department, Office of Tax Analysis, WPT receipts from private parties declined from a high of $12.9 billion in fiscal 1981 to $3.1 billion in 1985, and for the period 1986-1988, the Department estimated that a total of approximately $2 billion was collected.

[7] The Stipulation of Facts in the New Jersey Tax Court (J.A. 9 to 25) covers ten of the appellants. There is no indication that the facts applicable to the remaining three companies differ materially from those which were stipulated.

[8] But *see* footnote 28 at 41-42 below discussing the efforts of a Texas drilling company to obtain leases near the town of Readington, New Jersey.

sell at the wellhead some small portion of the domestic crude oil which they produce and acquire from third parties, but there is nothing in the record indicating their gross receipts for federal income tax purposes derived from sales of crude oil at the wellhead (J.A. 18 to 19). Generally the substantial majority of their crude oil production and the crude acquired from third parties is transferred from their exploration/production divisions downstream into their refining divisions (J.A. 18). Since these downstream transfers are made from one corporate division to another, they do not generate income for federal income tax purposes. Treas. Reg. § 1.61-3(a).

D. Assessments and Proceedings Below

On their federal income tax returns, the companies either deducted the WPT as a tax expense under IRC § 164(a)(5) or deducted it as an ordinary and necessary business expense under IRC § 162 (*see* App. B8 and Appendix A to this brief at 3a[9]) or included the WPT as part of their cost of goods sold, which was deducted from their sales to arrive at gross profit under IRC § 471. In computing their New Jersey CBT liabilities, they took the position that the WPT is not a tax "on or measured by profits or income" and therefore claimed a deduction for the tax on their New Jersey returns.

Relying in part on the State of New York's disallowance of a deduction for the WPT under virtually identical

[9] Appendix A is drawn from the federal income tax and New Jersey CBT returns of one of the companies for the years at issue, with the name omitted, three zeros dropped from the numbers, and the numbers rounded to the nearest $100,000. As shown at 3a, appellant X deducted the WPT as a tax expense on line 17 of its federal return.

statutory language,[10] the New Jersey Division of Taxation determined that the WPT is a tax "on or measured by profits" within the meaning of the tax disallowance provision in the New Jersey CBT Act. Having failed to obtain relief at the administrative level, the companies filed complaints in the Tax Court of New Jersey.

The New Jersey Tax Court concluded that the WPT is a tax "on or measured by profits or income" within the meaning of the tax disallowance provision and rejected the companies' constitutional claims (J.S. App. 47a to 48a).

The Appellate Division of the Superior Court of New Jersey reversed the Tax Court, reasoning that the purpose of the tax disallowance provision is to preserve the same tax base under the CBT as the base upon which the federal income tax is imposed and that the CBT should not deny deductions for what the court considered legitimate business expenses (J.S. App. 41a).

The Supreme Court of New Jersey reversed the Appellate Division and found that the base and measure of the WPT fit within ordinary concepts of "income" and "profits." The court noted the distinctive language in the preliminary definition of entire net income in N.J.S.A. 54:10A-4(k) (*see* Motion to Affirm, App. 1a to 2a), which is referenced to federal income tax concepts, and the language in the tax disallowance provision using the broader, general words "income" and "profits" (J.S. App. 13a to 14a).

[10] Opinion of Counsel, *Deductibility of Federal Windfall Profits Tax Under Article 9-A*, 1 [N.Y.] St. Tax Rep. (CCH) ¶ 9-909 (May 28, 1982).

The court rejected the companies' arguments under the Due Process and Commerce Clauses because, in its view, New Jersey is not adding out-of-state income to the base but, rather, is denying a deduction in arriving at the net income of the companies' unitary businessses, and denial of the deduction is neither triggered by the interstate nature of the companies' businesses nor favors in-state activities (J.S. App. 33a to 34a). The Equal Protection Clause is not violated, according to the court, because oil producers that have benefitted from the lifting of crude oil price controls and for that reason pay the WPT are the persons denied the deduction under the New Jersey CBT (*id.*). Finally, the New Jersey Supreme Court rejected the companies' Supremacy Clause argument on the ground that there is no evidence that Congress intended to preclude the states from denying a deduction for the WPT (*id.*).

SUMMARY OF ARGUMENT

This is an attempt by integrated oil companies to exempt from the New Jersey CBT a portion of their unitary net income equal to the WPT. The fact that the WPT Act segregates and defines for federal taxation what Congress deemed to be a discrete portion of the companies' profits does not mandate that New Jersey follow suit and withdraw that amount from the companies' unitary stream of income. The states are not bound by Congress' adoption of a form of separate accounting in the federal tax laws and may reject such accounting in favor of formulary apportionment. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 184-193 (1983).

There is no dispute that these vertically integregated oil companies are unitary businesses. Thus, under *Exxon Corp. v. Wisconsin Dept. of Revenue,* 447 U.S. 207 (1980), New Jersey may impose its CBT on its share of the companies' unitary net income, including income attributable in some degree to crude oil production activities outside New Jersey. The companies do not dispute this conclusion (App. B3).

During the years at issue (1980 and 1981) the companies' unitary net income included not only a normal profit attributable in some measure to crude oil production outside New Jersey but also a "decontrol element" or "windfall profit" produced when, beginning in 1979, domestic oil prices were decontrolled. Absent enactment of the WPT in 1980, it is clear that under *Exxon v. Wisconsin* New Jersey could tax this unitary net income including the windfall profit or decontrol element, and the companies do not dispute this fact.

Enactment of the WPT does not alter New Jersey's ability to tax the companies' unitary net income including the entire decontrol element. Their income equal to their WPT payments is as much a part of their unitary stream of income as (1) their so-called crude oil production income held subject to an apportioned state tax in *Exxon v. Wisconsin* and (2) the portion of the windfall profit remaining after payment of the WPT, which the companies tacitly concede New Jersey may tax.

It is irrelevant that the WPT may be a "real economic cost," a "cost . . . of earning income," or a cost paid "out of income" (U.S.B28). Income for state tax purposes may differ from federal gross or taxable income. *Atlantic Coast Line R. Co. v. Daughton,* 262 U.S. 413, 422-423 (1923).

The New Jersey CBT is a case in point. Although the starting point for computing net income under the CBT may be federal taxable income prior to the net operating loss deduction and special deductions, the adjustments which are made in arriving at the state tax base, including the denial of a deduction for federal taxes based on income or profits, can and do depart from federal income tax concepts (J.S. App. 13a to 14a).

The Court has made clear that state taxes are to be judged by their "practical effect" rather than formalisms or statutory words in a vacuum. *Nippert v. Richmond,* 327 U.S. 416, 433 (1946); *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). When the issue is properly framed in terms of its practical effect, the companies' claims of extraterritorial and discriminatory taxation collapse because the portion of unitary income which the companies want to exclude from the New Jersey net income base (an amount equal to between 70% and 20% of the windfall profit, IRC § 4987(b)), is no different in character from the unitary income equal to the remainder of the windfall profit (30% to 80%) which is included in the base without objection from the companies. The geographic incidence and so-called site-specific nature of the WPT are red herrings because New Jersey is taxing its share of unitary net income, and unitary net income is not site-specific.

Even on the companies' terms, there is no geographic skewing of the New Jersey net income base, first because they cannot establish that New Jersey is including out-of-state income in the tax base while denying a deduction for associated costs, and second because the WPT is not a site-specific cost. So far as income in the ordinary course of

their businesses is concerned, the companies have no income for either federal income tax or New Jersey CBT purposes until they sell their oil or petroleum products. Treas. Reg. § 1.61-3(a). For all this record reveals, the companies' activities in New Jersey may have accounted substantially for their ultimate taxable income. *Mobil*, 445 U.S. at 438; *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 276 (1978).

In any event, the WPT is not a site-specific cost because its computation depends on many factors having nothing to do with the property where the oil is produced. The removal price, in particular, depends on such factors as the value of the oil when it reaches a refinery and transportation costs. In the case of Alaskan oil, the refinery is apt to be thousands of miles from the producing property, in New Jersey for instance, and transportation costs depend upon the applicable tariff for transporting the oil through the Trans-Alaska Pipeline System and the contractual arrangements for transporting the oil by ocean-going tanker from Valdez to the West, Gulf, or East Coasts. *GAO Report*, App. I at 5, 10, 12-14, 20, 28-32.

The denial of a deduction for the WPT neither singles out for disadvantageous tax treatment an exclusively out-of-state activity nor otherwise discriminates against interstate commerce. Any singling out was accomplished by Congress when it determined that certain crude oil producers and other holders of an economic interest with respect to taxable crude oil should pay the WPT. IRC § 4996(a)(1)(A). New Jersey cannot be faulted for applying its facially neutral, longstanding tax disallowance provision to those corporations which pay the WPT.

New Jersey's application of its tax disallowance provision to the appellants is not drawn along state lines, and thus the provision, as applied, does not violate the purpose of the Commerce Clause to create an economic free trade zone. *Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984). No in-state activity is being favored. The companies' in-state competition, which includes independent marketers who do not pay the WPT to the federal government and are thus not subject to the tax disallowance provision, is as much involved in interstate commerce as are the companies. *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117 (1978).

Acceptance of the companies' position would create a legal nightmare. The rule would apply differently from state to state depending upon the location of crude oil. Many other so-called site-specific costs would become the subject of litigation, *e.g.* percentage depletion, intangible drilling costs, refining costs, and real property taxes. It is not apparent how a constitutional rule could be limited to situations where the site-specific nature of the cost is immutable, *e.g.* a function of a state's natural resources or lack thereof. An individual taxpayer having particularized site-specific costs outside the taxing state would be as constitutionally harmed as the victim of so-called "systemic" geographic skewing (U.S. B22). Even the definition of a site-specific cost would be problematic.

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ARGUMENT

I. APPLICATION OF THE NEW JERSEY CBT TO AN APPORTIONED SHARE OF APPELLANTS' ENTIRE NET INCOME, INCLUDING AN AMOUNT EQUAL TO THE WPT, FALLS SQUARELY WITHIN THE COURT'S PRECEDENTS

A. This Case Is Controlled By Exxon Corp. v. Wisconsin Dept. of Revenue

The Commerce and Due Process Clauses, together, impose four conditions on the imposition of a state tax. There must be a nexus between the corporation and the taxing state, the tax must be fairly apportioned to activities within the state and fairly related to in-state benefits, and the tax must not discriminate against interstate commerce. *Complete Auto Transit,* 430 U.S. at 287; *D.H. Holmes Co., Ltd. v. McNamara,* 108 S. Ct. 1619 (1988). State taxes are to be judged under this four-part test based on their "practical effect" and the "economic realities" of the situation. *Maryland v. Louisiana,* 451 U.S. 725, 756 (1981); *Complete Auto Transit,* 430 U.S. at 279; *National Bellas Hess Inc. v. Illinois,* 386 U.S. 754, 756 (1967).

Under the nexus requirement states are permitted to apply formulary apportionment to the entire unitary net income of a multistate corporation. *Mobil Oil Corp. v. Commissioner of Taxes,* 445 U.S. 425, 439 (1980). Unitary net income is income earned in a series of transactions that do not allow its precise source to be determined. *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113, 121 (1920); *Mobil,* 445 U.S. at 438.

In *Exxon v. Wisconsin,* the Court held that even though there was no crude oil production in Wisconsin and Exxon could identify through its accounting procedures a separate profit for its exploration and production division, Wisconsin could nevertheless include this so-called situs income in the tax base and subject it to formulary apportionment. Since Exxon's business was unitary and the production income was part of a unitary stream of income, there was a sufficient nexus between that income and Wisconsin to satisfy both the Due Process and Commerce Clauses. 447 U.S. at 226-230. Although a producing state might tax the production income in some manner, that income was in part attributable to Exxon's activities in Wisconsin, and thus the possibility of double taxation did not impugn Wisconsin's taxing scheme. *Id.* at 229. The tax was "fairly related" to benefits provided by Wisconsin consisting of various state services. *Id.* No issue was raised that the tax discriminated against interstate commerce.

The companies admit that their integrated petroleum operations, beginning with exploration and production, moving on to refining and manufacturing, and ending with income-generating sales, are unitary businesses (App. B3) and that they have a very substantial nexus with New Jersey (J.A. 12 to 15). The companies' unitary income attributable in some measure to their oil production activities is thus as taxable here as it was by Wisconsin in *Exxon v. Wisconsin.*

Included in the companies' unitary net income for the years at issue is income attributable to the federal government's decontrol of crude oil prices. This "decontrol element" of the companies' unitary net income includes an

amount equal to the "windfall profit" which Congress isolated and defined in the WPT. Inclusion of the decontrol element and the part of it which is equal in amount to the windfall profit does not alter the character of the unitary income stream held taxable in *Exxon v. Wisconsin*. In fact, the companies do not suggest otherwise, conceding *sub silentio* that New Jersey can impose the CBT on the decontrol element of their unitary net income which is left after subtracting an amount equal to the WPT. For Tier 1 oil, for instance, they tacitly concede that New Jersey can include in their unitary income 30% of the windfall profit, which is the amount left after subtracting an amount equal to the 70% WPT on the windfall profit for Tier 1 oil. IRC § 4987(b).

The "practical effect" of denying a deduction for the WPT is to include in the companies' unitary net income the entire decontrol element, including the windfall profit. Since they have not shown that the decontrol element "was earned in the course of activities unrelated to the sale of petroleum products in" New Jersey, *Mobil*, 445 U.S. at 439, New Jersey may apply its apportionment formula to the entire amount unless the Constitution obliges New Jersey to abandon formulary apportionment in the CBT and comply with the separate accounting used by Congress in identifying a windfall profit in the WPT Act.

B. New Jersey Is Not Constitutionally Compelled to Follow the Federal Government's Treatment of the WPT

Implicit in the companies' argument is the notion that enactment of the WPT somehow preempts the normal operation of New Jersey's CBT. But there is not one word

to that effect in the WPT Act or any other federal statute or regulation, and preemption cannot be inferred from silence. *Puerto Rico Dept. of Consumer Affairs v. Isla Petroleum Corp.*, 56 U.S.L.W. 4307 (April 19, 1988). Absent preemption, the fact that the WPT is deductible for federal income tax purposes does not oblige New Jersey to grant a similar deduction. Congress made the WPT deductible for federal income tax purposes so that the decontrol element would not be taxed twice by the federal government—once by the WPT and a second time by the federal income tax. H.R. Rep. No. 96-304 at 45; S. Rep. No. 96-394 at 68. New Jersey does not have its own WPT, and there is thus no logical necessity for making the WPT deductible for New Jersey income tax purposes.

It is immaterial that the WPT may be a "real economic cost" (U.S. B27 to 28) or includable in cost of goods sold (App. B8). The states are not required to follow federal definitions of net income, and there is no single definition of taxable income. *Atlantic Coast Line R. Co. v. Daughton*, 262 U.S. 413, 422 n.6, 423 (1923). Even in the absence of federal taxable income, a state can tax an apportioned share of a unitary corporation's net income computed on some other basis. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924). Income for state tax purposes may exist without realization, *see Atlantic Richfield Co. v. Alaska*, 705 P.2d 418, 421 (Alaska 1985), *appeal dism'd*, 474 U.S. 1043 (1986), may include as income items not thought to constitute income for federal income tax purposes, *Commissioner of Revenue v. Massachusetts Mutual Life Ins. Co.*, 384 Mass. 607, 428 N.E. 2d 297, 305 (Mass. 1981), and deductions may be denied that under the fed-

eral income tax might be deemed "real economic costs." *Atlantic Coast Line R. Co.; Mobil Oil Corp. v. Ley*, 142 Wis. 2d 108, 416 N.W.2d 680 (Ct. Ap. 1987), *pet. for rev. denied* (May 3, 1988).

In the New Jersey CBT, the adjustments to entire net income depart from the concept of federal taxable income. N.J.S.A. 54:10A-4(k) (J.S. App. 13a to 14a). In addition to the disallowance for "taxes paid to the United States on or measured by profits or income," a portion of interest on debt to 10% or more shareholders, net operating losses, and the federal income tax were not allowed as deductions under the CBT in the years at issue.[11] These are as much "real economic costs" as is the WPT.

In the WPT Congress may have isolated a discrete portion of the companies' unitary income, namely the windfall profit, but Congress' application of a separate accounting concept in a federal tax does not force New Jersey to do likewise. New Jersey need not abandon the unitary business principle and formulary apportionment and in its place adopt the federal government's assumption in the WPT Act of a definable, separable wellhead profit. *Container Corp.*, 463 U.S. at 184-197. As the companies themselves recognize (App. B19), quoting from *Mobil*, 445 U.S. at 438:

> Separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale.

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[11] N.J.S.A. 54:10A-4(k)(2)(D), (E) and (C) (App. to Motion to Aff. in No. 87-453 at 2a). Until 1985, N.J.S.A. 54:10A-4(k)(2)(D) disallowed the federal net operating loss deduction permitted under IRC § 172. 1985 N.J.L. c. 143.

C. Denial of a Deduction for the WPT Meets the Four-Part Test of Complete Auto Transit, Inc. v. Brady

New Jersey is taxing net income, not deductions, and it is thus the nature of the taxed income that is determinative, not the nature of the disallowed cost. The only constraints on the states' denial of so-called site-specific out-of-state costs are those set forth in *Complete Auto Transit*, to which we now turn.

Denying a deduction for a so-called out-of-state cost does not eliminate the nexus between appellants' so-called oil production income and New Jersey. The companies have a very substantial presence in New Jersey (J.A.12 to 15), and the measure of the tax remains New Jersey's share of their unitary net income. Thus, as the Solicitor General correctly points out (U.S. B17 and n.17), the practical economic effect of denying a deduction for the WPT is not the equivalent of New Jersey's imposing its own WPT or a severance tax on oil producing activities outside New Jersey. If this were not the case, no state could deny a deduction for a so-called situs-based tax arising outside its borders, *e.g.*, real estate taxes, severance taxes, or stock transfer taxes (even if the state denied a deduction for a similar in-state tax) because denying the deduction would effectively impose that kind of situs-based tax on out-of-state activities.

For analogous reasons, denial of a deduction for the WPT does not convert the CBT to a tax which is not "fairly related" to the cost of benefits provided by the

state. Since the companies do a substantial business in New Jersey and since the measure of the tax remains a share of their unitary net income, the measure continues to be related to governmental costs incurred to provide a civilized society. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 628-629 (1981), *and see* U.S. B17.

Denial of a deduction for the WPT does not transform New Jersey's fairly apportioned tax to one that is unfair. The companies do not question the propriety of New Jersey's three-factor formula (App. B14). Nor do they question New Jersey's right to apply that formula to the decontrol element of their entire net income apart from an amount equivalent to the WPT. See above at 16. How New Jersey's apportionment of the companies' net income becomes unfair when New Jersey subjects to formulary apportionment the remaining portion of the decontrol element is unclear.

What is clear is that denial of the deduction does not violate any of the Court's precedents dealing with fair apportionment. First, denial of the deduction meets the Court's internal consistency test. *Container Corp.*, 463 U.S. at 169. If every state denied a deduction for the WPT, the result would be that the entire portion of the decontrol element equivalent in amount to the WPT, but no more than 100% of that amount, would be subject to tax. While a producing state might separately account for oil production income and tax the full amount of that income within its borders, this does not preclude New Jersey from taking that income into account in determining the companies' apportionable New Jersey income. *Moorman Mfg.*, 437 U.S. at 273. What New Jersey is taxing is its

share of the companies' worldwide production, refining, and marketing income. A producing state which uses separate accounting is also measuring income within its borders but doing so by a different method. Double taxation, should it exist, "is not the inevitable result of the [New Jersey] taxing scheme." *Container Corp.*, 463 U.S. at 188; *Exxon v. Wisconsin*, 447 U.S. at 228-230.

Denial of the deduction meets as well the Court's external consistency test, *Container Corp.*, 463 U.S. at 169, because there is no proof that application of the three-factor formula to the companies' unitary net income, including an amount equal to the entire decontrol element and windfall profit, does not "actually reflect a reasonable sense of how income is generated." *Id.* Since the companies concede that New Jersey can subject a portion of the decontrol element of their unitary income to formulary apportionment, there cannot be an inherent or inevitable asymmetry (*cf.* App. B22 to 25) in apportioning the income equal in amount to the remainder of the decontrol element. The difference is merely the amount of income subjected to apportionment.

There is no proof in this record that subjecting the companies' unitary income, including an amount equal to the WPT, to New Jersey's apportioned tax attributes too much of their net income to the state. Ten of them argued below that virtually all of their income is derived from "post-'removal' sales to third parties of . . . barrels [of crude oil] or finished products refined therefrom" (Brief of Atlantic Richfield Company *et al.*, Superior Court of New Jersey, Appellate Division, Docket Nos. A-2795-84T7 and following, at 68. *See also* J.A. 18

to 19). The companies realize no income until their crude oil has been sold (generally away from the wellhead) or refined, manufactured, and sold. Treas. Reg. § 1.61-3(a). What New Jersey is taxing is an apportioned share of that realized income. N.J.S.A. 54:10A-4(k); N.J.S.A. 54:10A-5(c) (J.S. App. 94a to 95a). The companies concededly have extensive operating facilities in New Jersey (J.A. 12 to 15). There is no proof in this record that New Jersey's share of the companies' unitary net income, including the full decontrol element, was not earned as much through the companies' refining, manufacturing, petrochemical operations, and selling activities in New Jersey as through their oil production activities in other states.

The amount of CBT owed by the companies when a deduction for the WPT is denied is not excessive. *Cf.* App. B23. As made clear in the table included in Appendix C to this brief, in all but two cases for the two years at issue, imposition of a 1% gross receipts tax on each of the companies' New Jersey receipts would have yielded a greater tax than did imposition of the CBT on their apportioned entire net income without a deduction for the WPT. *See Moorman Mfg.*, 437 U.S. at 280-281.

Denial of a deduction for the WPT does not make the CBT discriminatory in application. If New Jersey can constitutionally tax the companies' unitary income including a portion of the decontrol element, the CBT does not become discriminatory when New Jersey taxes their unitary income equal in amount to the remainder of the decontrol element. State lines are as irrelevant here as they were in *Exxon v. Wisconsin*, and "the Commerce Clause is not offended when state boundaries are economically

irrelevant." *American Trucking Ass'ns v. Scheiner*, 107 S.Ct. 2829, 2840 (1987). The "practical economic effect" of denying a deduction for the WPT is simply to include in the unitary tax base an amount equal to the entire decontrol element. This does not threaten the economic free trade area protected by the Commerce Clause. *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 328 (1977).[12]

II. APPELLANTS' ASSERTION THAT THE WPT CREATES A CONSTITUTIONAL BARRIER TO THE NORMAL OPERATION OF NEW JERSEY'S CBT HAS NO BASIS IN LAW

The companies repeatedly assert that denial of a deduction for the WPT impermissibly skews the unitary net income base, singles out for disadvantageous tax treatment an exclusively out-of-state activity, and discriminates against interstate commerce. Indeed, if repetition of the charged words "tailored" and "skewed," without more, could win the day, there would be no hope for the CBT.

A. There Is No Impermissible Skewing of the Tax Base

Denial of a deduction for the WPT does not skew the net income base of the CBT regardless of whether the WPT is a site-specific cost. If New Jersey can tax an apportioned share of the companies' unitary net income

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[12] The Equal Protection Clause, which provides alternative, but no greater, constitutional protection for out-of-state corporations, *Western & Southern Life Ins. Co. v. State Bd. of Equalization*, 451 U.S. 648 (1981), does not present a separate issue here. *See* App. B41, 48; U.S. B10.

including income attributable in some degree to their crude oil production activities in other states, which it clearly can under *Exxon v. Wisconsin*, and if New Jersey can tax the segment of the decontrol element of their unitary income which is left after subtracting an amount equal to the WPT, which the companies tacitly concede is permissible, the net income base does not suddenly become skewed when New Jersey taxes the portion of unitary income equal in amount to the WPT. Whether the WPT is site-specific is irrelevant.

Even under the companies' and the Solicitor General's formulation of the issue, there is no skewing of the tax base because, first, the companies do not and cannot establish that the tax base includes a disproportionate amount of out-of-state income, and, second, the WPT is not a site-specific cost. New Jersey is neither taxing "out-of-state income unencumbered by out-of-state costs" (App. B30), nor is it "asymmetrically including receipts without allowing deductions for associated costs" (U.S. B16).

1. Appellants Have Not Shown That New Jersey Is Taxing Out-Of-State Income

As pointed out above at 21-22, no income is realized for income tax purposes absent a sale or other event which triggers realization, and the bulk of the companies' gross receipts derive from the sale of petroleum products, not from sales of crude oil at the wellhead. Nothing in this record establishes the amount of the companies' gross receipts from sales of crude oil at the wellhead (*cf.* J.A. 18 to 19), and even if such an amount could be established, the figure would include receipts from sales of crude oil

produced by the companies on which they paid the WPT and sales of crude oil *purchased* from other producers on which the companies, as purchasers of the oil, did not bear the burden of the WPT (*id.*).[13] Since the companies' net income arises from a series of transactions beginning with exploration and production, with no income for tax purposes absent a sale, *Bass, Ratcliff*, 266 U.S. at 282 (1924), they have no way of establishing that their net income is attributable in any specific amount to any particular geographic location. *Mobil*, 445 U.S. at 438. In light of the companies' extensive operations in New Jersey, it is just as plausible to assume that the bulk of their unitary net income was attributable to refining, manufacturing, and marketing activities within the state as it is to assume that their unitary net income was attributable to oil production outside New Jersey. *Moorman Mfg.*, 437 U.S. at 272.

The companies would have this Court remove from the CBT base a segment of their unitary net income equal to the WPT. Since this segment of their income is economically real, it is misleading to equate its inclusion with the doubling of income from an out-of-state activity (*cf.* App. B28), doubling the numerator of the companies' payroll fraction (*cf.* App. B24), or excluding oil production property from the denominator of their property fraction (*cf.* App. B25). Any of these adjustments would artificially augment their business income by factors bearing no relation to economic reality.

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[13] The WPT is paid by the producer, but the first purchaser must withhold and remit the tax, much as in the case of federal income tax withholding. IRC § 4986(b); IRC § 4995(a)(1).

2. In Any Event, The WPT Is Not Site-Specific

The entire factual predicate for the companies' and the Solicitor General's position is that the WPT is a purely site-specific and exclusively out-of-state cost (App. B14 to 18; U.S. B23 to 25), and both concede that their theory applies "*only* to costs that are properly identified as site specific" (App. B31; U.S. B21, emphasis supplied). In fact, the WPT is not site specific.[14] At least three factors necessary to its computation—the removal price, inflation adjustment, and net income limitation—are not site-specific.

The removal price is either the sales price, or, if there is no sale (as in the case of a downstream transfer to an integrated oil company's refinery), the removal price is "the representative market or field price of the oil or gas before conversion or transportation." IRC § 4988(c); Treas. Reg. § 1.613-3(a). The representative market or field price depends upon what price the crude oil will bring in the marketplace, which may or may not be in the vicinity of the producing property, and if the market is not in the vicinity, the market price must be reduced by transportation costs. Rev. Rul. 83-161, 1983-2 C.B. 202. Although unique in many ways, Alaskan North Slope oil is a case in point. As Exxon's vice president of supply testified in hearings on the windfall profit tax and Alaska North Slope oil producers (*"ANS Hearing"*):[15]

> For crude run in our own refineries, the value [of Alaska North Slope crude oil for WPT purposes] is determined on a continuing basis from our best assessment of the term [sic] market value of the crude *in the area where it is refined*, for example, west coast or gulf [/] east coast.
>
> . . . . .
>
> We believe our approach for establishing the removal price is appropriate because the key determinants in valuing North Slope crude, *or any other crude, for that matter*, are the price it will bring in the marketplace and the transportation cost to get it there. [*ANS Hearing* at 11, emphasis supplied].

Seven of the companies have interests in Alaskan North Slope oil, and of these Atlantic Richfield and Exxon have sizable interests. *GAO Report*, App. I at 6.[16] In 1982, 8% of Alaska North Slope ("ANS") oil was delivered through the Trans-Alaskan Pipeline System and by ocean-going tankers to the East Coast, some of this to New Jersey,[17] while 47% was delivered to the West Coast and 32% to the Gulf Coast. *Id.* at 6, 8. Since there are no

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[14] While New Jersey has stated, correctly, that the WPT has "a geographic source outside the State," it has never conceded that the so-called oil production income on which the WPT is imposed is an exclusively out-of-state segment of appellants' unitary business income and has consistently maintained that the WPT is unlike a site-specific severance tax (Motion to Affirm at 14; Brief in Response to U.S. at 10 n.9).

[15] *The Windfall Profits Tax and Product Marketing Consequences of the Wellhead Pricing Practices of Alaska North Slope Crude Oil Producers: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce* (February 23, 1983).

[16] *See* fn. 5 above.

[17] In 1982 Exxon's share of ANS oil averaged 325,000 barrels per day, of which approximately two thirds or 216,645 barrels were delivered to the Gulf and East Coasts. Of this amount, 30% or 64,994 barrels per day were delivered to Exxon's only refinery on the East Coast in Linden, New Jersey. *ANS Hearing* at 10; *National Petroleum News, Fact Book Issue*, Mid-June 1981 at 204.

sizable markets near the North Slope, a "wellhead price, per se, does not exist for North Slope oil." *Id.* at 10. Producers thus construct a removal price for purposes of the WPT by valuing the oil at the refinery gate in a market area in the lower 48 states and deducting transportation costs from this amount. Rev. Rul. 83-161, 1983-2 C.B. 202. During the period covered by the *GAO Report*, Exxon determined the wellhead value of its ANS crude based on an assessment of its market value in the area where the crude was refined, *GAO Report*, App. I at 13, including Exxon's Bayway Refinery in Linden, New Jersey. Atlantic Richfield valued all its ANS crude based on the market price for West Texas Sour in the Gulf Coast even when the oil was delivered to the company's West Coast refinery. *Id.* at 13, 10; *ANS Hearing* at 5.[18] Some of the smaller producers used foreign crude oil as a benchmark to determine the value of their ANS oil. *GAO Report*, App. I at 14.

Further differences in the removal price of ANS oil result from differing transportation costs. Some of the producers use their own tankers to transport the oil, *e.g.* Atlantic Richfield, while others use chartered tankers, *e.g.* Exxon, *id.* at 13, 29, and the eight owners of the Trans-Alaska Pipeline System charge different tariffs to transport the oil from the North Slope to Valdez. *Id.* at 20. Further differences relate to the deduction of field

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[18] The difficulty of valuing ANS oil is underlined by the recent assessment of $1 billion in WPT deficiencies and interest for the period 1980-1983 against Atlantic Richfield on account of the company's valuation of its ANS oil. *See Wall Street Journal*, July 19, 1988 at 6; *New York Times*, July 19, 1988 at D1.

costs and pipeline losses and to the time at which a removal price is established. *Id.* at 14-15. Some producers determine a price for WPT purposes at the wellhead when the oil is removed, while others value the oil upon delivery to a refinery, *e.g.* in New Jersey, which may be two or three months after removal. *Id.*

ANS oil is not the only oil to be valued based on factors far distant from the wellhead. As Exxon's vice president of supply testified (see above at 27), the same kinds of factors apply in establishing the value (or removal price) of any crude oil. In fact, the basic measure of wellhead value is the "posted price," which is the price that refiners, often located at a substantial distance from the field, are willing to pay for the oil based on their own demand and supply factors at the time. *See e.g.* Revision of Oil Product Valuation Regulations, 53 Fed. Reg. 1184, 1220 (January 15, 1988) (Dept. of Interior, Minerals Management Service).

The inflation adjustment is a significant component in computing the windfall profit. The adjustment increases the base price to arrive at the adjusted base price, and the adjusted base price (plus severance tax adjustment) is deducted from the removal price to determine the taxable windfall profit. IRC § 4989(a); IRC § 4988(a). The inflation adjustment, defined in IRC § 4989(b), increases the base price by the amount of inflation in the gross national product since June 30, 1979. An additional adjustment is permitted for Tier 3 oil. IRC § 4989(b)(2). During the period at issue the inflation adjustment for Tiers 1 and 2 ranged from 1.95% in the first quarter of 1980 to 18.61% for the fourth quarter in 1981 (J.A. 30).

Price inflation in the general economy is plainly not tied to a single oil producing property.

The net income limitation ("NIL"), which substantially reduced the companies' WPT liabilities during the years at issue (JA. 21), is not a site-specific computation and is a computation made, not at the time of removal, but rather on an annual basis. IRC § 4988(b)(2). It is thus fundamentally incorrect to state that the WPT is measured at the time of removal (*cf.* App. B35). The WPT is not fully measured until the end of the taxable year. For crude oil not sold at the wellhead the starting point for computing the NIL is affected by the same off-site factors, that affect the removal price, *i.e.* the value of the oil in the market where it is refined and transportation costs. IRC § 4988(b)(3); Treas. Reg. § 51.4988-2(b)(i). Once gross income from the property is determined, a producer deducts all expenses directly attributable or allocable to the production process with the exception of percentage depletion, the WPT itself, intangible drilling costs, and certain "qualified tertiary injectant expenses." IRC § 4988(b)(3); Treas. Reg. § 51.4988-2(b)(ii).[19] Deductible expenses include operating expenses, certain selling expenses, administrative and financial overhead, depreciation, taxes deductible under IRC § 162 or 164, losses sustained, and exploration and development expenditures. Treas. Reg. § 1.613-5(a). At the very least, administrative and financial overhead and income taxes deductible under Section 162 or 164 are not site-specific costs.[20] The form on which the companies compute the NIL (J.A. 32 to 33) confirms that expenses incurred away from the producing property such as "overhead" (Line 7) and "expenses not solely attributable to the production of taxable crude oil" (Line 10) are deductible in determining the taxable income from the property.

[19] Although disallowed as current deductions, these expenditures, with the exception of the WPT, are recovered over time through cost depletion in the NIL computation. IRC § 4988(b)(3)(C).

It is thus inaccurate to state, as does the Solicitor General, that "the measure of the windfall profit tax is a figure tied to the particular producing property (in a particular state) at the time of removal" (U.S. B25). It is equally inaccurate to state, as do the companies, that the WPT is "effectively measured by the value of crude oil at the time and place of removal" (App. B17). The measurement depends upon market factors including, in the case of Exxon's East Coast deliveries of ANS Oil, the value of that oil to Exxon at its refinery in New Jersey, inflation in the general economy, and an annual net income computation which takes into account so-called "bot-

[20] *Shell Oil Co. v. Commissioner*, 89 T.C. 371 (1987), involved several issues in computing the NIL. The United States Tax Court upheld Shell's position that interest expense incurred in connection with Shell's acquistion of the Belridge Oil Company was a general corporate overhead expense which could be allocated among Shell's producing and nonproducing properties thereby reducing Shell's net income for purposes of the NIL. The parties agreed that state income and franchise taxes were part of general corporate overhead to be allocated among Shell's various activities based upon relative net income. The parties disagreed as to whether the WPT should be included in a base under which indirect expenses would be allocated to Shell's producing properties. The court held that the WPT could be included in the base because enactment of the WPT caused the taxpayer to incur additional administrative costs.

tom line" taxes (U.S. B25) and general corporate overhead.

The companies and the Solicitor General are in a distinct minority in their view that the WPT is a site-specific cost akin to a severance tax. The WPT does not meet Congress' definition of a severance tax in the WPT Act itself because it is not measured by the "gross value of the extracted oil." IRC § 4996(c)(2); Treas. Reg. § 51. 4996-2(b). Nor is the WPT imposed on the act of removal but rather on the windfall profit. IRC § 4986. The Internal Revenue Service states in its manual: "Although the WPT is by Congressional definition an excise tax, its structure and computation bear more resemblance to an income tax." *I.R.S. Manual Supplement—Windfall Profit Tax Program*, 42 RDD-57 (Rev. 3) August 28, 1987 § 2.01. This Court, in its brief characterization of the WPT, has called it a tax on "additional revenues," *Ptasynski*, 462 U.S. at 76, and state and lower federal courts have agreed. *Exxon Corp. v. City of Long Beach*, 812 F.2d 1256, 1259 (9th Cir. 1987); *Tenneco West, Inc. v. Marathon Oil Co.*, 756 F.2d 769, 773 (9th Cir. 1985) *cert. den.* 474 U.S. 845 1985); *Crocker National Bank v. McFarland Energy, Inc.*, 140 Cal. App. 3d 6, 10, 189 Cal. Rptr. 302, 304 (Ct. App. 1983); *Lewis v. Reagan*, 516 F. Supp. 548, 553 (D.D.C. 1981).[21]

[21] The shorthand characterization of the WPT as a severance tax in the committee reports (H.R. Rep. No. 96-304 at 2; S. Rep. No. 96-394 at 2) cannot override Congress' definition of a severance tax in the Act itself in such manner as to exclude the WPT, nor does that characterization accurately describe the actual operation of the WPT, which resembles to some extent

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This is not to say that the WPT operates exactly like the federal income tax. The WPT is a unique tax (*GAO Report*, App I at 1), having characteristics of both an income tax and a transactional excise tax. As the WPT is truly unique, it does not advance the inquiry to suggest as does the Solicitor General (U.S. B24 to 26), that, as New Jersey has no comparable tax for which it denies a deduction, New Jersey should not be able to deny a deduction for the WPT. If, as the Internal Revenue Service maintains, the WPT more closely resembles an income tax, under the Solicitor General's theory, those states that deny a deduction for the federal income tax, including New Jersey, may deny a deduction for the WPT. *See* Appendix B to this brief.[22]

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an income tax. The characterization of the tax in IRC § 4986(a) as an excise tax does not imply that it is site-specific. The excise tax on the undistributed income of regulated investment companies, which precedes the WPT in the Internal Revenue Code, is not, under appellants' apparent understanding of the concept, site-specific. IRC § 4982. The CBT itself is an excise or franchise tax. J.S. App. 29a to 30a; *Cities Service Co. v. Taxation Div. Director*, 5 N.J. Tax 257, 271 (N.J. Tax Ct. 1983).

[22] The companies' suggestion that the WPT resembles a severance tax because a producer remains liable for the tax even if the oil is lost subsequent to removal (App. B35) and the Solicitor General's suggestion that the WPT operates like a severance tax in that it functions as a cost of earning income not as a payment out of income earned (U.S. B28) are not borne out by the facts of this case. The companies lose virtually no barrels of oil subsequent to removal (J.A. 19), and some of them treated the WPT as a tax expense paid out of income earned rather than as a cost of earning income. *See* Appendix A to this Brief at 3a, 1a. In any event, the failure to allow a credit or refund on account of downstream losses and imposition of the tax in the process of earning income would not negate the fact that the measurement of the WPT is not geographically localized, which is the entire foundation for the companies' and the Solicitor General's position.

B. The CBT Is Not Tailored To Disadvantage Out-of-State Oil Producers and Does Not Otherwise Discriminate Against Interstate Commerce

1. Congress, Not New Jersey, Singled Out Oil Producers For Special Tax Treatment

Whatever tailoring or singling out there may be in this case was accomplished, not by New Jersey, but by Congress in determining that oil producers should pay a special tax. *See* U.S. B13. In those instances where Congress determined that certain oil should not be burdened by the WPT, *e.g.* certain Alaskan oil,[22A] New Jersey's tax disallowance provision does not come into play. Conversely, where Congress determined to impose the WPT at a lower rate, e.g. on newly discovered oil, New Jersey's tax disallowance provision operates with a reduced effect, and where Congress chose to impose the WPT at the highest rate, *i.e.* 70% on Tier I oil produced by integrated companies, New Jersey's tax disallowance provision operates accordingly. IRC § 4987(b). The CBT does not even single out integrated oil producers. *Cf.* App. B24. The tax disallowance provision applies to any corporation which pays the WPT, including chemical companies and conglomerates (J.A. 34), and any other "holder of the economic interest with respect to [taxable] crude oil." IRC § 4986(b); IRC § 4996(a)(1). As the Internal Revenue Service states in its manual, "[The WPT] will affect almost every taxpayer who owns any kind of interest in an oil well." *I.R.S. Manual Supplement, supra,* § 2.02. A

22A IRC § 4991(b)(3); IRC § 4994(e); *see also Ptasynski*, 462 U.S. at 78.

New Jersey pharmaceutical company or real estate development company having a limited partnership investment in a drilling partnership would be subject to the WPT and the CBT's tax disallowance provision. Treas. Reg. § 51.4996-1(b)(2).

The companies are simply wrong in asserting that New Jersey is "singling out for special tax burdens a form of business activity conducted only in other jurisdictions" (App. B44). Out-of-state oil production is neither the subject nor the measure of the CBT. New Jersey is imposing the CBT on the companies' exercise of the privilege of doing business in New Jersey measured by their apportioned New Jersey income. N.J.S.A. 54:10A-2; N.J.S.A. 54:10A-5(c) (J.S. App. 93a to 95a).

There is no indication that New Jersey has lowered the CBT rate on in-state activities nor increased the rate on out-of-state activities. The Commerce Clause is not violated merely because a state tax increases the cost of doing an interstate business. *Western Livestock v. Bureau of Revenue,* 303 U.S. 250, 254-255 (1938); *Washington Rev. Dept. v. Stevedoring Ass'n,* 435 U.S. 734, 748 (1978).[23]

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23 The American Mining Congress and the Natural Gas Supply Association argue that formulary apportionment assumes roughly equal rates of return in every jurisdiction and that denying a deduction for the WPT violates this assumption because the result is too much oil production income in relation to other income. But for the reasons stated at 24 to 25 above, there is no evidence that New Jersey is taxing too much income attributable to oil production. Unless appellants can show that the entire apportionment formula (*i.e.* the net income base including the full decontrol element, multiplied by the three-factor apportionment formula) results in significant

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Any number of state tax provisions may have a disparate effect on intrastate and interstate commerce and yet not be discriminatory. For instance, New Jersey denies a deduction for the federal income tax under the provision at issue here. The provision does not become discriminatory because some industries doing primarily an interstate business have a higher effective federal income tax rate (and thus a bigger federal income tax disallowance in New Jersey) than have some other industries doing primarily an in-state business. Likewise, an interstate industry with heavy capital investment and eligible to claim the accelerated cost recovery system ("ACRS") deduction under IRC § 168[24] is not discriminated against by

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distortion, it does them no good to attack only a single element in the equation. *Norfolk & W.R. Co. v. North Carolina*, 297 U.S. 682, 688 (1936). Moreover, the premise of the argument is wrong. In the short run, rates of return most likely do vary from jurisdiction to jurisdiction, one factor being the "difficulty [and in the case of crude oil production, the impossibility] of shifting resources," *Container Corp.*, 463 U.S. at 183, n.20, and another factor being severe market shocks such as the actions of the OPEC cartel and the lifting of domestic oil price controls. As made clear in *Container*, formulary apportionment is nevertheless acceptable absent proof that separate accounting is more accurate. *Id.* at 183-184. Here, as distinct from the situation in *Container*, there is no evidence at all that separate accounting for the amount of the WPT would produce a more accurate computation of appellants' unitary income.

[24] ACRS is effective for tangible property placed in service after 1980 and before 1987. Pub.L.No.97-34, § 201(a); 95 Stat. 204-205; Pub.L.No.99-514, § 203(a)(1)(4), 100 Stat. 2143; IRC § 168. ACRS, in general, liberalized the rules for recovering the cost of depreciable property. IRC 168(b) (prior to amendment by Pub.L.No.99-514). ACRS was modified in 1984 and curtailed by the Tax Reform Act of 1986 for property placed in service after December 31, 1986. IRC § 168 (as amended by Pub.L.No. 99-514).

the disallowance in the CBT of the excess of the ACRS deduction over pre-1981 federal income tax depreciation. N.J.S.A. 54:10A-4(k)(2)(F) (Motion to Affirm, App. 3a).

2. Exxon v. Maryland Disposes of Appellants' Discrimination Claim

Even if New Jersey had singled out integrated oil companies for special tax treatment, the tax disallowance provision would be constitutional under *Exxon v. Maryland*, 437 U.S. 117 (1978). There, the Court upheld a Maryland statute that prohibited integrated producers and refiners from retailing gasoline within the state against the claim that the statute discriminated against interstate commerce. *Id.* at 124-125. As Maryland had no crude oil production or refineries, there could be no disparate treatment of similar in-state activities, and since the independent marketers with whom the integrated producer refiners competed were not wholly intrastate, the distinction drawn by the statute was not based on state lines but on the nature of the companies' businesses. *Id.* at 125-126; *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 42 (1980). Nor did the regulation affect the flow of goods in interstate commerce, because, again, the independent retailers were as much a part of that commerce as the integrated producer refiners. *Exxon v. Maryland*, 437 U.S. at 126, n.16. Similarly here, to the extent that integrated oil companies can be thought to bear a cost that independent marketers do not, that distinction is not based on state lines, but rather on the nature of the companies'

businesses and the fact that Congress decreed they should pay the WPT.[25]

3. The New Jersey State Line Is Irrelevant Here

Denying a deduction for the WPT neither favors the local New Jersey economy nor sets New Jersey apart from the other states. There is no in-state oil production, and

[25] Appellants, the Solicitor General, and *amici* Committee on State Taxation of the Council of State Chambers of Commerce *et al.* ("COST") suggest that *Exxon v. Maryland* is distinguishable because it involved a state regulatory, rather than a tax, measure, and COST more pointedly states that state regulatory measures are entitled to more deference under the Commerce Clause than state taxes (App. B48; U.S. B22 n.22; COST B15 and n.16). The only authority cited for this proposition is *Freeman v. Hewitt*, 329 U.S. 249 (1946), where a majority of the Court held that a direct tax on commerce would be struck down for that reason alone and buttressed its holding by stating that, as a state could obtain its revenues from other sources than a direct tax, a state tax was owed less deference than a police regulation incidentally affecting commerce. 329 U.S. at 253. The distinction between direct and indirect taxes on interstate commerce disappeared with *Complete Auto Transit*, and the notion that a state tax is subject to stricter scrutiny because "revenue serves as well no matter what its source" should follow the same path. The fact that a state *could* have chosen another levy as a revenue source says nothing about the practical effect of the levy it *did* choose. Moreover, the absence of a balancing test in *Complete Auto Transit* and the Court's other tax cases under the Commerce Clause indicates that a state's "significant interest" in raising revenue to support its sovereign government, *Washington v. Stevedoring Ass'n*, 435 U.S. at 748, is sufficiently strong that in the absence of a protectionist motive or effect, that interest generally outweighs any incidental effect on interstate commerce. In this respect it might be said that state taxes that are not clearly protectionist are entitled to *greater* deference under the Commerce Clause than state regulatory measures, which are subjected to a balancing test. *See Pike v. Bruce Church*, 397 U.S. 137, 142 (1970); *Hughes v. Oklahoma*, 441 U.S. 322, 331, 336-338 (1979).

if there were the tax disallowance provision would apply equally to it. The tax disallowance provision thus does not have the tendency to force comparable out-of-state activities to be performed in-state. *Cf. Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 406 (1984); *American Trucking Associations*, 107 S.Ct. at 2842. As no comparable in-state activity is being favored, more than a "slight twist" distinguishes this case from *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977) and *Westinghouse Electric* (*cf.* App. B43 to 44). It is a contradiction in terms to maintain that a state tax discriminates against interstate commerce if it does not advantage some in-state element or single out the taxing state for advantageous treatment. As the Court pointed out in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984):

> Virtually every discriminatory statute allocates benefits or burdens unequally; each can be viewed as conferring a benefit on one party and a detriment on the other, in either an absolute or relative sense. [*Id.* at 273].

Where, as here, no in-state element is being favored, an essential element in the discrimination equation is missing. While independent marketers may be treated differently under the CBT because they do not pay the WPT,[26] that

[26] Appellants' example purportedly showing that producer/marketers have a higher net income than non-producer/marketers solely on account of New Jersey's denial of a deduction for the WPT (App. B46) suffers from the same misconception as the rest of their argument. As the WPT is a function of a producer/marketer's so-called wellhead profit, which in turn is part of the producer/marketer's unitary net income, the example merely establishes that a company with higher profits has a larger New Jersey tax base. Indeed, the price paid by the non-producer/marketer reflects the WPT, if any, paid by the producer.

distinction does not relate to state lines. *See* U.S. B13. As no in-state element is favored, cases like *Westinghouse Electricc. American Trucking*, and *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64 (1963), have no bearing here.

Amici Committee on State Taxation of the Council of State Chambers of Commerce and others ("COST") point to *Philadelphia v. New Jersey*, 437 U.S. 617 (1978), for the proposition that a state statute can discriminate against interstate commerce even though it favors no in-state interest (COST B19). While the New Jersey statute in that case did not necessarily favor local economic interests, it manifestly drew a distinction based on the New Jersey state line. Out-of-state garbage could not be dumped in New Jersey landfills, while in-state garbage could be. Here, the New Jersey state line is irrelevant. New Jersey has not set up a wall around itself and is not isolating itself from the national economy.

Denying a deduction for the WPT will not lead to "economic Balkanization" (*cf.* COST B6 to 7, 11 to 14). Since New Jersey is taxing the in-state attributes of the companies' unitary businesses and is drawing no distinctions based on state lines, other states have no cause to complain. COST's claims that we are witnessing the opening salvos of a trade war between the producing and nonproducing states (COST B13) are belied by the facts that Kansas, which in 1986 produced 67,034,000 barrels of crude oil, has recently denied a deduction for the WPT (*see* App. B33 n.14) and that California and Wyoming,

both of which have substantial oil production,[27] have joined in an *amicus* brief, along with other producing and nonproducing states, on New Jersey's behalf.

III. APPELLANTS' PROPOSED CONSTITUTIONAL RULE WOULD BE UNWORKABLE

The Court once observed that its Commerce Clause decisions in the state tax area "have been 'not always clear . . . consistent or reconcilable . . .' " and has characterized those decisions as a "quagmire." *Portland Cement Co. v. Minnesota,* 358 U.S. 450, 458 (1959). In *Complete Auto Transit* the Court clarified the area by establishing a straightforward four-part test. The companies' proposed constitutional rule, which would prohibit the states from denying a deduction for a so-called site-specific cost when the cost is incurred exclusively, or almost exclusively, out-of-state would destroy the clarity achieved in *Complete Auto Transit.*

A. The Rule Would Apply Differently From State To State Depending Upon The Location Of The Activity for Which a Deduction is Being Denied

New Jersey presently has no oil production nor proved reserves. It is not out of the question that the situation might change.[28] Under the companies' theory, Kansas,

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[27] U.S. Dept. of Energy, Energy Information Administration, Office of Oil and Gas, *Petroleum Supply Annual,* Table 9 (May, 1987) (hereafter "1987 *Petroleum Supply Annual*").

[28] On October 4, 1983, the *New York Times* reported at page B1, that brokers for a Texas drilling company had been

(Continued on following page)

which denies a deduction for the WPT (App. B33 n.14) and has a substantial amount of oil production, would not be subject to attack. New York, which is an *amicus* in this case, had oil production in 1986 amounting to 853,-000 barrels. Appellants imply that New York's provision denying a deduction for the WPT, which is virtually identical to New Jersey's, is unconstitutional (App. B16), but what about Pennsylvania with 3,783,000 barrels of production in 1986, or Michigan, another *amicus* in this case, with 1986 production of 25,688,000 barrels?[29] Where is the line to be drawn?

Several states have no oil refineries.[30] If the Court adopted the companies' argument in this case, presumably they would insist that these states could not deny deductions for any refinery costs.

Depletion is another so-called site-specific cost. As pointed out in New Jersey's brief in response to the United States at 7 to 8, for federal income tax purposes, there are two kinds of depletion—cost and percentage. As it is based on income from a producing property rather than

(Continued from previous page)

seeking to lease mineral rights in Somerset and Hunterdon Counties near the town of Readington, New Jersey. Readington lies over a geologic formation called the Newark Basin, thought to contain reserves of crude oil. The company subsequently withdrew from New Jersey after drilling an exploratory well across the Delaware River in Pennsylvania which came up dry. *Newark Star Ledger*, October 25, 1985, at 29.

[29] 1987 *Petroleum Supply Annual.*

[30] As of January 1, 1980, there were no oil refineries in Connecticut, Idaho, Iowa, Maine, Massachusetts, Rhode Island, South Carolina, South Dakota, or Vermont. *National Petroleum News, Fact Book Issue, supra* at 203-205.

capital costs, percentage depletion is often more advantageous than cost depletion. In 1975, Congress eliminated the deduction for percentage depletion for most oil and gas producers, including those like appellants which refine or retail oil. IRC § 613A(d)(2); IRC § 613A(d)(4). Percentage depletion continues to apply at the federal level for numerous other minerals. IRC § 613(b). Many states have their own depletion rules. *See* Appendix B to this brief and *see generally*, 1 Multistate Corp. Income Tax Guide (CCH) ¶ 89. To the extent that minerals eligible for percentage depletion under federal law are not found in a state that limits all depletion to cost, acceptance of the companies' position would raise the question whether denial of a deduction for percentage depletion unconstitutionally skews the net income base.

B. As Applied To The WPT The Rule Would Be Irrational

Congress enacted the WPT in the belief that the additional profits realized by oil producers as a result of the decontrol of oil prices and actions of the OPEC cartel should be further taxed. To do so it enacted a separate tax and made that tax deductible for federal income tax purposes. IRC § 164(a)(5). Certain crude oil is taxed at a lower rate, *e.g.* newly discovered oil, and some is exempted entirely, *e.g.* certain Alaskan oil. IRC § 4987; IRC § 4991 (b). Under the companies' proposed rule, the states would be allowed to tax in full income attributable to the oil

which Congress exempted from the WPT, and conversely would be precluded from taxing through their own corporate net income taxes income attributable to the oil which Congress subjected to tax. Absent preemption, which plainly is not the case here, the Constitution should not be read to produce such an irrational result. Nor should the other taxpayers of New Jersey be constitutionally required to subsidize a portion of the WPT liabilities of integrated oil companies.

C. Defining A Site-Specific Cost Would Be Extremely Difficult

As pointed out above, the WPT is not a site-specific cost. The companies assume that a severance tax is site-specific, but what about a so-called state severance tax measured by the net proceeds of production?[31] Would *ad valorem* property taxes using an assessed value based on sales of comparable properties or the discounted income stream from a property be site-specific? Many states deny a deduction for other states' income taxes. *See* Appendix B. For a company doing 99% of its business in state A and 1% of its business in state B, would the income tax of state A be site-specific such that state B could not disallow it in computing the apportionable income of the corporation? Another of the federal income tax

[31] Minnesota has a tax of 2% on the net proceeds of mining, which allows a deduction for certain ordinary and necessary business expenses, depreciation, and certain exploration and development expenditures. 2 State Tax Guide, All States (CCH) ¶ 45,519. Nevada taxes the net proceeds of mining with deductions for certain costs of production, depreciation, royalties, state unemployment and social security contributions. *Id* at ¶ 45,261.

deductions disallowed under the CBT is a portion of interest paid on debt owed to 10% or more shareholders. The Solicitor General suggests that such interest is not site-specific (U.S. B21), but would that be true for mortgage interest paid with respect to out-of-state property from funds generated by the property?

D. The Rule Suggested By The Solicitor General Would Not Do Justice In Individual Cases

The Solicitor General suggests that the rule would apply only where the asserted skewing is "systemic, and not limited to particular taxpayers based on the fortuity of the locations of parts of their businesses" (U.S. B22). If the Commerce Clause "forbids discrimination . . . against interstate commerce on the specific facts of each case," *Exxon v. Maryland*, 437 U.S. at 151 (dissenting opinion), the Solicitor General's proposed rule is unacceptable. Under it an integrated oil company having all its crude oil production in Alaska, California and Texas (and thus, under the Solicitor General's and the companies' theory, its WPT "sited" in those states) could not complain if Kansas (which has crude oil) denied a deduction for the WPT. Despite the fact that, as to that taxpayer, the disallowed cost would be entirely out-of-state, there would be no impermissible skewing of the income base. Because Kansas has crude oil, the skewing would not be "systemic."

The Solicitor General's suggestion that the rule would apply only where the geographic skewing was 'of significant magnitude" and "obvious" is equally unsatisfactory. The Court has made clear that *any* discrimination against interstate commerce is unacceptable no matter how slight

and that it need not know how discriminatory a tax is before striking it down. *Maryland v. Louisiana,* 451 U.S. at 760; *Bacchus Imports,* 468 U.S. at 269. How large would the skewing have to be to violate the Constitution? Has the WPT deduction declined to such an extent due to falling crude oil prices (*see* above at 6 and Motion to Affirm at 10-11 and n.8) that it is no longer of constitutional magnitude?

The Court has long recognized the states' ability to exercise their sovereign power of taxation and the diversity of state tax schemes and has declined to prescribe uniform rules in this area. *Wisconsin v. J.C. Penney Co.,* 311 U.S. 435, 444 (1940); *Portland Cement,* 358 U.S. at 457; *Moorman Mfg.,* 437 U.S. at 278-280. This policy of restraint, combined with the intrusiveness of a blanket rule prohibiting the denial of a deduction for an out-of-state cost should lead the Court to reject the companies' position as it did in *Moorman Mfg., Exxon v. Wisconsin,* and *Container Corp.,* 463 U.S. at 185-189.

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CONCLUSION

For the foregoing reasons the judgment of the Supreme Court of New Jersey should be affirmed.

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APPENDIX

APPENDIX A

X CORP.

PRO FORMA SEPARATE COMPANY BASIS

FORM 1120—U.S. CORPORATION INCOME TAX RETURN

		000 Omitted	
		1980	1981
1	Sales	$15,333,900	$17,092,900
2	Less: Cost of goods sold	10,540,300	11,644,800
3	Gross profit	4,793,600	5,448,100
4	Dividends	372,900	83,500
5	Interest on obligations of the United States and U.S. instrumentalities	6,500	500
6	Other interest	107,000	11,300
7	Gross rents	117,600	116,700
8	Gross royalties	2,400	1,600
9	(a) Capital gain net income	29,200	17,400
	(b) Net gain or (loss) from Form 4797	1,100	13,800
10	Other income	(15,500)	40,500
11	TOTAL income	5,414,800	5,733,400
12	Compensation of officers		
13	Salaries and wages	363,200	421,900
14	Repairs	517,400	603,600
15	Bad debts	4,000	
16	Rents	169,200	193,300
17	Taxes	1,234,600	1,477,700

X CORP.

Form 1120 continued--

		000 Omitted 1980	1981
18	Interest	150,800	269,900
19	Contributions	1,900	13,400
20	Amortization	2,500	2,900
21	Depreciation	461,500	596,000
22	Depletion	111,100	72,000
23	Advertising	36,800	49,600
24	Pension, profit-sharing, etc. plans	142,400	143,200
25	Employee benefit programs	5,400	5,700
26	Other deductions	1,304,700	1,724,200
27	TOTAL deductions	4,505,500	5,573,400
28	Taxable income before net operating loss deduction and special deductions	909,400	160,000
29	Less: Special deductions	366,000	75,000
30	Taxable Income	543,400	85,000
31	TOTAL TAX	67,200	5,500

X CORP.

Schedule A Form 1120, Line 2, Cost of Goods Sold

1	Inventory at beginning of year	471,800	480,200
2	Merchandise bought for manufacture or sale	9,251,600	10,577,200
3	Salaries and wages	132,900	284,800
4	Other costs	1,164,300	863,000
5	Total	11,020,600	12,205,200
6	Less: Inventory at end of year	480,200	560,400
7	Cost of goods sold	10,540,500	11,644,800

X CORP.

Form 1120, Line 17, Schedule of Taxes

	000 Omitted 1980	1981
F.I.C.A.	$ 33,800	$ 44,100
Federal Unemployment Insurance	1,300	1,300
State Unemployment Insurance	2,300	2,500
Foreign Payroll	400	100
State and Local Income Taxes	13,000	(9,300)
Franchise Taxes Measured by Income	4,300	4,300
Property Taxes	76,400	87,500
Production Taxes	154,600	230,800
Transportation Taxes	1,200	1,000
Sales and Use Taxes	14,500	62,300
General Corporate Taxes	622,400	34,600
Windfall Profit Tax	310,300	1,018,500
Total Taxes	$ 1,234,500	$ 1,477,700

X CORP.

CBT—100 NEW JERSEY CORPORATION BUSINESS TAX RETURN

Sch. A—Computation of Entire Net Income and Tax Based on Entire Net Income. Every Corporation Must Complete This Schedule. Federal Schedules Are Acceptable For Lines 1-28.

		1980	1981
Gross Income			
1	Gross receipts or gross sales	Lines 1-27. See Attached Federal Returns	
2	Less: Cost of goods sold and/or operations.		
3	Gross profits		
4	Dividends		
5	Interest on obligations of the United States and U.S. instrumentalities		
6	Other interest		
7	Gross rents		
8	Gross royalties		
9	(a) Capital gain net income (attach separate Federal Schedule D)		
	(b) Net gain or (loss) from line 11, Part II, Form 4797 (attach Federal Form 4797)		
10	Other income (attach schedule)		
11	TOTAL income—Add line 3 through 10		

000 Omitted

		1980	1981
Deductions			
12	Compensation of officers (Schedule F-1)		
13	Salaries and wages (not deducted elsewhere)		
14	Repairs (Do not include capital expenditures)		
15	Bad debts		
16	Rents		
17	Taxes (Sch. H)		
18	Interest		
19	Contributions		
20	Amortization		
21	Depreciation (Attach Copy of Federal Form 4562 or Other Federal Depreciation Schedule)		
22	Depletion		
23	Advertising		
24	Pension, profit-sharing plans, etc.		
25	Employee benefit programs		
26	Other deductions (attach Schedule)		
27	TOTAL deductions—Add lines 12 through 26		
28	Taxable income before net operating loss deduction and special deductions—Line 28, Federal Form 120	$ 909,400	$ 160,000

		1980	1981
29	Interest on Federal, State and Municipal obligations	1,100	
30	Interest paid to shareholders	-0-	-0-
31	N.J. Corporation Tax	100	1,100
32	Total	910,600	161,100
33	Less: Dividend Exclusion	359,700	68,700
34	Total	550,900	92,400
35	Other Adjustments	-0-	-0-
36	Adjusted Entire Net Income	550,900	92,400
37	Allocation factor	.012877	.013564
38	Allocated net income (Line 36 x Line 37)	7,100	1,300
39	Investment company	-0-	-0-
40	Regulated Investment Company	-0-	-0-
41	Entire Net Income Tax Base	7,100	1,300
42	Entire Net Income Tax (Line 41 x 9%)	639	113

APPENDIX B

DEDUCTIONS ALLOWED UNDER STATE CORPORATE NET INCOME TAXES FOR DEPLETION, STATE INCOME TAXES, AND THE FEDERAL INCOME TAX.

Sources: *Multistate Corporate Income Tax Guide*, Vol. I (CCH); *State Tax Guide, All States*, Vol. 1 (CCH, 2nd ed.)

	Depletion	State Inc. Tx.	Fed. Inc. Tax
Alabama	Cost exc Oil & Gas @ 27½%	No	Yes
Alaska	SAF*	No	No
Arizona	Percentage but rates differ fr. Fed.	No exc Arizona	Yes
Arkansas	SAF	Yes exc Ark	No
California	SAF but modified for Oil & Gas & Sulphur	No	No
Colorado	SAF But 27½% for Oil Shale	Yes exc Colo	No
Connecticut	SAF	Yes exc Conn	No
Delaware	SAF exc Only Cost for Oil & Gas	Yes exc Del	No
Dist. of Columbia	SAF	No	No
Florida	SAF	No	No
Georgia	SAF	No exc GA	No
Hawaii	SAF	Yes	No
Idaho	SAF	No	No
Illinois	SAF	Yes exc Ill	No
Indiana	SAF	No	No
Iowa	SAF exc Cost for Oil, Gas & Geothermal	Yes exc Iowa	50%
Kansas	SAF	No	No

* "SAF" indicates that the state treatment is the "same as federal" income tax treatment.

	Depletion	State Inc. Tx.	Fed. Inc. Tax
Kentucky	SAF	No	No
Louisiana	SAF exc 22% for Oil & Gas	Yes exc La	Yes
Maine	SAF	No	No
Maryland	SAF exc Cost for Oil	No	No
Massachusetts	SAF	No	No
Michigan	SAF	No	No
Minnesota	Cost	No	No
Mississippi	Cost Limit; Percentage Computation	No	No
Missouri	SAF	No	Yes
Montana	SAF But Only Cost for NOL	No	No
Nebraska	SAF	Yes	No
Nevada	No Corp. Inc. TX		
New Hampshire	SAF	No	No
New Jersey	SAF	Yes exc NJ	No
New Mexico	SAF	Yes	No
New York	SAF	No	No
New York City	SAF	Yes exc NYS&C	No
North Carolina	Cost except for solid minerals located in No. Car., for which Fed. % depl. rules apply.	No	No
North Dakota	SAF	No	Yes
Ohio	SAF	Yes	No
Oklahoma	SAF exc 22% for Oil & Gas	No	No
Oregon	Cost exc 15% for Metal Mines	No	No
Pennsylvania	SAF	No	No

	Depletion	State Inc. Tx.	Fed. Inc. Tax
Rhode Island	SAF	Yes exc R.I.	No
So. Carolina	SAF w/ in-State Option	No	No
So. Dakota	No corp. tax on gen'l bus. corps.		
Tennessee	Cost Limit; Percentage Computation	Yes exc Tenn	No
Texas	No Inc. Tx		
Utah	SAF	No	No
Vermont	SAF	Yes	No
Virginia	SAF	No	No
Washington	No Corp. Inc. TX		
W. Virginia	SAF	No	No
Wisconsin	Cost	No	No
Wyoming	No Inc. Tx.		

Additional Explanation of State Income Tax Deduction for Depletion in Those States Where Such Deduction Differs From that Prescribed by the Internal Revenue Code of 1986.

Source: *Multistate Corporate Income Tax Guide,* Vol. 1 (CCH), except where otherwise indicated.

Alabama permits percentage depletion for oil and gas only. The rate is 27½% of gross income from the property. Cost depletion applies to all other natural deposits and timber. CCH Par. 2058.28.

Arizona allows percentage depletion on certain minerals at rates from 5% to 23% of gross income from mining but not in excess of 50% of taxable income derived from mining. The rate for oil, gas and geothermal wells is 27½% of gross income from the property also not exceeding 50% of taxable income derived from the well. CCH Par. 2152.

California follows the federal treatment except that, in the case of oil and gas wells and geothermal deposits, percentage depletion is permitted at the rate of 22% of gross income from the property not to exceed 50% of net income from the property. However, depletion of oil and gas wells, geothermal deposits and sulphur mines is subject to the following reduction: Depletion in excess of $1.5 million is reduced by 125%. The effect is to eliminate depletion when aggregate deductions total $7.5 million. CCH Par. 2258.48.

Colorado follows the federal treatment except that oil shale may be depleted at 27.5% rather than 15%. CCH Par. 2308.31.

Delaware follows the federal treatment except that only cost depletion is available for oil and gas wells. CCH Par. 2404.

Iowa follows the federal treatment of depletion except in the case of oil, gas or geothermal wells where the deduction is limited to cost depletion. CCH Par. 2802.

Kentucky follows the federal treatment for depletion purposes with a limited exception in connection with the disposal of coal and iron ore.

Louisiana follows the federal treatment except in the case of oil and gas wells where percentage depletion must be used if it results in a larger deduction than cost depletion. The rate for oil and gas wells is 22% of gross income from the property not to exceed 50% of net income before depletion. CCH Par. 2958.73.

Maryland follows the federal treatment except in the case of oil wells where only cost depletion is allowed. CCH Par. 3058.09.

Minnesota allows only cost depletion with a limited exception in the case of copper and nickel mines for tax years which began before 1987. CCH Par. 3208.39.

Although Mississippi permits percentage depletion (except in the case of timber), aggregate deductions may not exceed the cost basis of the property. The effect is to limit taxpayers to deducting the cost basis of their property but such recovery can occur more quickly than if deductions were required to be computed under the cost method. CCH Par. 3258.17.

Montana follows the federal treatment except for purposes of computing a net operating loss. The effect is to

permit taxpayers the full benefit of percentage depletion if there is sufficient taxable income in the year in which the depletion deduction arises. CCH Par. 3358.14.

North Carolina allows percentage depletion in the case of solid minerals located in North Carolina; otherwise the deduction is limited to cost depletion. CCH Par. 3708.34.

Oklahoma follows the federal treatment except in the case of oil and gas where percentage depletion at the rate of 22% of gross income not to exceed 50% of taxable income from the property, is permitted. CCH Par. 3858.06.

Oregon permits only cost depletion except in the case of metal mines which are eligible for a deduction of 15% of gross income from the property not to exceed 50% of net income from the property. CCH Par. 3904 and *State Tax Guide, All States,* Vol. 1 (CCH 2nd ed.), Par. 10-760.

South Carolina follows the federal treatment but, in addition, affords taxpayers who allocate or apportion income, the option of eliminating depletion from pre-apportionment income and deducting from South Carolina taxable income after allocation and apportionment, percentage depletion on South Carolina deposits. There must be the possibility of a greater reduction in tax because of taxpayer's in-state properties eligible for depletion. CCH Par. 4052 and *State Tax Guide, All States,* Vol. 1 (CCH, 2nd ed.), Par. 10-803.

Although Tennessee follows the federal treatment, no further deductions are allowed once the cost basis of the property has been exhausted. The effect is to limit depletion to cost basis but to permit such basis to be re-

covered more rapidly than if the cost method were employed. CCH Par. 4158.15.

Wisconsin limits taxpayers to cost depletion. CCH Par. 4502.

APPENDIX C

GROSS RECEIPTS TAX RATE ON NEW JERSEY RECEIPTS REQUIRED TO YIELD ACTUAL TAX ON APPORTIONED NET INCOME WITH NO DEDUCTION FOR WPT.

	N.J. TAX PER DIV. TXN.	1980 N.J. RECEIPTS	REQUIRED GROSS RECEIPTS TAX RATE	N.J. TAX PER DIV. TXN.	1981 N.J. RECEIPTS	REQUIRED GROSS RECEIPTS TAX RATE
Amerada Hess	$12,504,242	$1,963,980,529	.006366	$7,561,840	$2,030,427,351	.003724
Atlantic Richfield	1,633,808	351,097,761	.004653	1,309,033	494,560,373	.002646
Chevron	6,947,422	595,196,591	.011672			
Cities Service	1,618,395	430,716,383	.003757	912,204	525,071,375	.001737
Conoco	523,399	215,713,000	.002426			
Exxon	19,038,950	1,733,219,568	.010984			
Gulf	997,987	418,110,012	.002386	1,356,153	494,547,325	.002742
Mobil	2,235,947	523,179,106	.004273			
Phillips	195,684	62,178,170	.003147			
Shell	3,509,330	507,607,824	.006913	5,031,746	518,628,982	.009702
Tenneco	592,949	98,920,231	.005994			
Texaco	5,064,761	525,955,022	.009629			
Union	384,965	54,471,208	.007067			

Source: Appendix A to Appellants' brief and the companies' New Jersey CBT returns which are included in the record. The New Jersey receipts of Tenneco and Gulf for 1981 are not in the record, but both companies provided these entries and consented to their use in this Appendix.